Daily Oil Bulletin

Productivity, Not Just Price, Real Solution To Surviving Low Oil Prices

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Figure 1: Oil Rigs being deactivated.

April 25, 2015: **Only 83 rigs out of a fleet of 754 were working this week across the entire Western Canadian Sedimentary Basin, resulting in just 11 per cent of the fleet being active**

Exploration and Production (E&P) companies and the Oilfield Services Sector (OFS) are once again embroiled in the latter half of their historic love/hate relationship. It's not pretty.

With oil prices down 50 per cent, clients are demanding vendors cut prices. Contracts mean little. Sue if you like. Some oil company executives are publicly telling investors they're firing suppliers that won't cut rates. Established relationships are secondary to E&P demands that vendors share the pain.

For OFS, compliance is painful, expensive and ultimately impossible. Baked-in high labour costs exist because relentless client demand has required it. Billions have been borrowed to finance massive, client-driven OFS investments in new drilling, service, fabrication, construction and transportation equipment. Reduced revenue is bad. No margin is worse because it ultimately means default and insolvency.

This game of pricing ping-pong has been going on for decades. Everybody talks about how it should be different, but current events have proven yet again it isn't. What isn't discussed enough is the real challenge — productivity. Lower commodity prices indeed require lower costs. But what matters most is the final capital investment per barrel. Total cost includes operational efficiency and time. Here's what our industry should really be talking about:

- The market cost of all OFS goods and services is ultimately driven by E&P demand. E&P is not a master of its own destiny either with investment driven by commodity prices, technology,

capital, market access and geological opportunity. The relationship between E&P and OFS is truly symbiotic; one cannot survive without the other. But you'd never know it during times like this.

- OFS must earn a margin every time its moves. Every job or sale carries risk. Capital and equipment require servicing. Staff must be retained. The size of the margin can vacillate but to work for nothing or less is suicide. Without at least some profit E&P is putting vendors out of business and OFS is putting itself out of business.
- Too many OFS managers don't grasp the full-cycle economics of hydrocarbon development. There is a lingering belief among many that E&P is fabulously profitable, which it is not. Successful operators generally treat their vendors fairly. Clients that appear generous today are often gone tomorrow.
- Operational execution is as important as unit input costs. Getting all the parts, people and services in the right place at the right time is exclusively E&P logistics. Some companies are very good while others are terrible. The amount of capital vaporized when clients aren't organized is huge. Hurry and wait. This inflates costs but has nothing to do with component prices.
- Oil company departments do not always communicate or co-operate. You'd think senior management would take a holistic approach to maximum recovery at the lowest cost per barrel, not per vendor. Exploration directs drilling where to construct a wellbore. Drilling is pressured to deliver the lowest cost wellbore, not always ideal for the reservoir. Completions does what it can with what it gets then production takes over. Too often a poorly drilled and completed wellbore yields only a fraction of management expectations. Vendors often know what works best but are seldom consulted at the E&P executive level.
- The biggest gains in total cost reduction come from process and technological improvement, not just component prices. Look no further than the dramatic increase in drilling penetration rates and steady decline in the cost of extended reach horizontal drilling and completions. Progress is impossible if vendors are undercapitalized or insolvent or if clients don't communicate or listen.
- The bizarre way E&P pays suppliers drives up costs. It is now common to not pay for 60 or 90 days or even longer. This is surely the worst client/vendor relationship in the western world. The huge cost of extending credit to customers is baked into prices. While E&P treasury believes it is saving money, operations and capital expenditures are priced higher to cover significant vendor financing expenses. If oil companies paid cash or sooner, OFS would happily reduce prices. Lower prices resulting from faster payment would improve E&P ROIC while leaving OFS margins intact.
- Every time oil or gas prices collapse OFS pricing is a key element of cutting costs. And it should be. Everybody in the food chain must share the pain. The collective survival of the industry requires co-operation and collaboration. When the Canadian oilpatch needs to retool to survive it always does. Somehow. It may not be pretty, but it will happen.

But the fundamental way in which most E&P and OFS companies interact remains mired in the past. Both sides are responsible; both sides are essential. A little more engagement by the senior executives on both sides might engender a new business relationship with a greater focus on cost per barrel than just component prices. In our high cost basin, improved productivity is critical for our collective success.